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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Periodic Reporting (UPS Proposals One, Two, and Three)	)))	Docket No. RM2016-2

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
THE VALPAK FRANCHISE ASSOCIATION, INC.
REPLY COMMENTS REGARDING UNITED PARCEL SERVICE, INC.'S
PROPOSED CHANGES TO POSTAL SERVICE COSTING METHODOLOGIES
(March 25, 2016)

Initial Comments filed by Valpak Direct Marketing Systems, Inc. and The Valpak Franchise Association, Inc.[1] ("Valpak") addressed only UPS Proposal One, but stated that Reply Comments may also address UPS Proposal Two. However, these Reply Comments again focus on UPS Proposal One.

I. Introduction

UPS Proposals One and Two under consideration in this docket have provoked an interesting and important re-examination of economic cost concepts, that can benefit the Postal Service as well as all mailers. Despite exhibiting widely differing views concerning attributable and incremental cost concepts, the Initial Comments of all parties seem to agree that whatever definitions and cost concepts the Commission finally adopts, they should apply equally to competitive and market dominant products. That is, no party has argued that cost attributed to market dominant products be defined or computed any differently than costs attributed to competitive products. Further, although the parties differ as to how incremental

[1] Formerly known as Valpak Dealers' Association.

costs should be computed, all seem to agree that whatever procedure the Postal Service uses to compute incremental costs should apply to competitive and market dominant products equally.[2]

Although the parties' Initial Comments focus on cost and cost concepts generally, it seems obvious from those Comments that the importance attached to costing derives from the fact that cost provides the basis for pricing. ACMA's Initial Comments, for example, state that:

> [t]he existing costing system … is designed to estimate costs that are **relevant to the rates being set.** [*Id.* at 2 (emphasis added).]

And the Postal Service's Initial Comments identify "marginal costs as the starting point for setting prices." USPS Initial Comments at 24. However, there is some difference in the basis for linkage between costs and prices between competitive and market dominant products.

For competitive products, the PAEA in so many words mandates prices must exceed costs. 39 U.S.C. § 3633(a)(2). For market dominant products, however, the linkage is based on the dictates of 39 U.S.C. § 101(d), 39 U.S.C. § 403(c), and good economics, and the Commission has concluded that the class-applied price cap cannot be breached to increase prices of the class above attributable cost. *See* UPS Response to ChIR No. 1, Q. 3 at 19.

II. Prevention of Cross-Subsidies Is an Essential Economic Cost Principle

Cross-subsidies arise when the price of one or more products does not cover all of the costs which those products caused the Postal Service to incur. The existence of cross-subsidies means that customers of that product (or group of products) are paying the Postal Service less

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[2] The Postal Service appears to agree, stating that UPS "ignores the fact that the Postal Service uses the same costing methodology for determining the attributable and incremental costs of both market dominant and competitive products." USPS Initial Comments at 26.

than the **incremental cost** the Postal Service incurs in offering of said product (or group of products). The equity consideration is that when some customers pay less than the cost of the benefits which they receive, other customers are compelled to pay extra to make up for those losses caused by other customers. Economists consider cross-subsidies to be undesirable not only because of equity considerations but also because sending improper pricing signals to customers causes general market distortion. These principles apply equally to market dominant and competitive products.

NPPC's Initial Comments point to the one statutory use of the term "cross-subsidy":

> [o]nly one provision of the Postal Enhancement and Accountability Act specifically addresses **cross-subsidization.** That is Section 3633(a)(1), which directs the Commission to adopt and revise as needed regulations to "**prohibit the subsidization** of **competitive products** by market-dominant products." 39 U.S.C. §3633(a)(1). [*Id.* at 4 (emphasis added).]

The Postal Service's Initial Comments reference a Report of the Treasury Department which states that "each **competitive product's revenues** [must] exceed its incremental costs" in order to guard against cross-subsidies. *Id.* at 8. Both the Commission and the Postal Service have been careful to prevent cross-subsidy of competitive products. However, with respect to cross-subsidization within market dominant products, both have been far more cavalier. In this respect, the Postal Service and the Commission have both erred in compelling some products to subsidize other mailers year after year, ever since passage of PAEA.

Although the PAEA expressly bars the cross subsidization of competitive products by market dominant products, whether viewed individually or collectively, as the Initial

Comments of the Public Representative ("PR") point out, **the spirit of the statute generally is to prevent all cross subsidization**:

> In the first rate case after NAGCP, the Commission recognized the responsibility of balancing two mandatory statutory responsibilities. PRC Op. R-84, para. 3025 at 131. Apart from correctly attributing costs, a secondary theme of the Supreme Court's Opinion in NAGCP was noted by the Commission as one to, "**Prevent cross subsidization of one class by another**." … It noted that while **cross-subsidy** is not always an unmitigated evil, it **has been condemned by the statute the Commission is required to carry out.** [*Id.* at 14 (emphasis added).]

Current postal law mandates that postal rates cover attributable costs as well as make a contribution to institutional costs. This requirement was contained in the Postal Reorganization Act of 1970, and continues in current postal law, unamended by PAEA:

> **[p]ostal rates shall** be established to **apportion the costs** of **all postal operations** to **all users of the mail** on a **fair and equitable** basis. [39 U.S.C. § 101(d) (emphasis added).]

PAEA reiterated and describes this principle as a "requirement,"[3] as follows:

> the **requirement** that each **class of mail or type of mail service** bear the direct and indirect **postal costs attributable** to each class or type of mail service through reliably identified causal relationships **plus that portion of all other costs** of the Postal Service **reasonably assignable** to such class or type. [39 U.S.C. § 3622(c)(2) (emphasis added).]

When 39 U.S.C. § 101(d) and 3622(c)(2) are viewed together, these provisions require not only that each **class** of mail generate sufficient revenue to cover its attributable costs, but they also require that **all postal rates** (for all postal products) cover attributable costs and pay

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[3] Although placed in a list of so-called pricing "factors," this pricing principle is identified as the only "**requirement**" among the "objectives" and "factors" in section 3622(b) and (c), respectively.

some "fair and equitable" share of unattributed costs, however small that portion might be. Therefore, the requirement that rates include some positive portion of the Postal Service's institutional costs is not irrelevant below the class level. Rather, under these two statutory tests, the Commission needs to subject to special examination prices for all postal products failing to cover their attributable costs, even if those products happen to exist within classes which make a positive contribution to institutional costs due to intra-class subsidies. Every piece that fails to cover attributable costs makes it that much more difficult for the Postal Service to generate the retained earnings that are necessary for financial stability.

This is not a new concept. In the FY 2009 ACD, the Commission noted that "[t]he desirability of rates that recover attributable costs and make reasonable contributions to institutional costs is also supported by [39 U.S.C. §] 3622(b)(1) ["To maximize incentives to reduce costs and increase efficiency"], and [39 U.S.C. §] 3622(b)(5) ["To assure adequate revenues, including retained earnings, to maintain financial stability]."[4] FY 2009 ACD, p. 68, n.5. The Commission has also concluded that underwater rates are unfair to other mailers. *Id.*, p. 31.

Then, in the FY 2010 ACD, the Commission discussed the requirement that products cover their costs:

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[4] In its FY 2009 ACD, the Commission applied 39 U.S.C. section 3622(c)(2) at the product level. *See, e.g.*, FY 2009 ACD, pp. 68 (First-Class Presort Parcels), 86 (Standard Mail Flats), 95 (Single-Piece Parcel Post, Bound Printed Matter Parcels, Media Mail/Library Mail, and Inbound Surface Parcel Post), 104 (Registered Mail and Stamped Cards), 106 (Address List Services), 107 (Confirm service), 111 (inbound letter post from Canada and Inbound Surface Parcel Post), and 112 (international inbound Registered Mail). *See also* FY 2008 ACD, pp. 72-73, 77.

> The Postal Service reads Order No. 536 as suggesting that pricing standards apply at the class level, not the product level. … While the Commission rejected the Postal Service's contention that the term "product" is the only appropriate level at which pricing standards apply, it did not rule out the possibility that certain pricing standards would apply at that level. Order No. 536 at 24-27. In this proceeding, consistent with prior ACDs, the Commission has appropriately applied the pricing standard at the product level.
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> In Order No. 536 the Commission observed that the terms the PAEA uses to indicate the level at which its various pricing standards apply are non-restrictive ("mail," "service," "class or type," "subclass," and "category.") The Commission noted that many of PAEA's pricing standards use language that is broad enough to include products, but does not restrict the application of the pricing standard to products. The Commission found this to be true of the ceiling on workshare discounts imposed by section 3622(e). In explaining why it arrived at that conclusion, the Commission discussed the terms used in other pricing provisions to indicate the level at which each provision should be applied. It noted with respect to the language section 3622(c)(2) uses to indicate the level at which the attributable cost floor applies:
>
>> The attributable cost floor applies to each 'class or type of mail [service].'. While this phrase is broad enough to include an individual 'product,' it is not confined to an individual product.
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> Order No. 536 at 26. [FY 2010 ACD at 17-18 (footnotes omitted).]

Consistent with this analysis, the Commission found that the failure of one product to cover its attributable costs violated PAEA, even if the class which that product was within did cover its attributable costs:

> [Commenters] claim that the intra-class subsidy, amounting to $1.4 billion over the last three years, including $577 million in FY 2010, violates 39 U.S.C. 101(d)…. The Commission agrees and concludes that the Standard Flats product is not in compliance with this important policy of title 39. [*Id*. at 16.]

Thus, even though not expressly mandated by PAEA, there is no question within the economic community, and prior Commission decisions, that product cross-subsidization is the polar opposite of rational and efficient pricing. In 2008, Stanford University Professor of Economics Frank Wolak, discussing "Implementing a Modern System of Regulation for the Postal Service under the Postal Accountability and Enhancement Act" (http://goo.gl/WwbTOA), placed responsibility to prevent cross-subsidies directly on the Commission:

> **An important role of the Postal Regulatory Commission is to ensure that market-dominant products are not cross-subsidizing other postal products.** This requires determining the volume-variable costs and product-specific fixed costs associated with all Postal Service products and then verifying that the **price charged** for each of those products **exceeds its average incremental cost** (the sum of volume variable cost and product specific fixed costs divided by the number of units of this product produced.). [*Id.* at 5 (emphasis added).]

The Commission should assume the role envisioned by Professor Wolak and take the initiative to require the Postal Service to eliminate all cross-subsidies whether by product or class, where there is no conflict with the price cap. Should the Commission somehow feel that PAEA in some way limits sound pricing, then in its forthcoming review of the PAEA, the Commission should alter the pricing rules to expressly prohibit cross-subsidy among market dominant products and to require any such cross-subsidy to be eliminated promptly.

In this docket, no Initial Comments have been so reckless to explicitly support cross-subsidization of market dominant products. However, some have expressed opposition to use of proper economic cost concepts such as incremental cost as a price floor (even when properly defined and computed; see below) which leave the door to cross-subsidization wide open. For example, the Initial Comments of ACMA *et al*. resist any costing change that would increase the amount of costs causally linked to any product:

> A number of market dominant-products and types of mail that now cover their reported attributable costs would see their reported coverage ratios fall below 100 percent: First-Class Mail Single-Piece Cards, First-Class Mail Parcels, Standard Mail Carrier Route, and Bound Printed Matter Parcels. Other products with coverage ratios below 100 percent would see the reported shortfalls widen dramatically. It is hard to see how these market dominant **products will benefit from** adoption of Proposals One and Two. [ACMA *et al*. Initial Comments at 5 (emphasis added).]

ACMA *et al*.'s assumption to the contrary, the purpose of proper cost attribution and any other legitimate effort to determine costs caused by a postal product is not to "benefit" the product(s) in question. Although the above statement by ACMA *et al*. does not explicitly advocate non-compensatory pricing — *i.e.*, deliberately setting a price below marginal cost — it implicitly urges acceptance of that practice. And non-compensatory pricing is just another term for cross-subsidization.

In an accompanying footnote, ACMA *et al*. are more explicitly unapologetic for non-compensatory pricing and the resultant cross-subsidization of underwater products by profitable products.

> **the Commission and the Postal Service are making significant efforts to make the rates for underwater products within classes equal to, or at least closer to, compensatory levels.** Thus, severe **price increases** could result from adoption of Proposals One and Two. And, as noted above, some products now covering attributable cost could fall below it, necessitating yet further efforts on the same lines. [ACMA *et al*. Initial Comments at 5, n.3 (emphasis added).]

Despite its attempt to provide cover for the Commission and the Postal Service, ACMA *et al.* know full well that Standard Flats has been underwater since the enactment of PAEA, and neither the Commission nor the Postal Service have made any material progress in reducing its cross-subsidy, much less eliminating it. Mailers of Standard Flats would obviously prefer to have other mailers unfairly and inequitably pay some of the costs which they cause the Postal Service to incur, despite 39 U.S.C. §§ 101(d) and 403(c).[5]

III. Economic Concepts of Attributable and Incremental Cost

Many comments in this docket center around two economic cost concepts: (i) attributable costs, and (ii) incremental costs. Some parties see these two concepts as being either-or alternatives, *i.e.*, one is in opposition to the other. But they are not — each concept has an important and complementary role in the pricing of postal products.

The Postal Reorganization Act established the role of attributable costs in postal ratemaking **by requiring** that "each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type." 39 U.S.C. § 3622(b)(3) (2005). PAEA implemented this same **requirement** in 39 U.S.C. § 3622(c)(3), adding the qualification that attributable costs be "through reliably identified causal relationships." Even though the actual term "incremental costs" is not used in either the PRA or the PAEA, in a 2014 report to

[5] Since the statute prohibits the Postal Service from using revenue from market dominant products to cross-subsidize competitive products, perhaps it feels that its statutory monopoly entitles it to force some market dominant mailers to cross-subsidize other market dominant mailers of its choosing.

the Commission, Dr. John C. Panzar stated that the appropriate test for cross-subsidization is the incremental cost test.

> It is now **standard in the regulatory economics literature** that **avoiding cross subsidization** means that the customers of each product (or group of products) **pay more** to the firm in revenues **than** the **incremental cost** of said product (or group of products). [John C. Panzar, The Role of Costs for Postal Regulation (2014) at 15 (emphasis added).[6]]

That unremarkable, widely accepted economic principle establishes the central role of incremental cost in setting a price floor for all products. Because these two concepts are central to the debate, it is important for the discussion that follows for each cost concept to be defined with precision.

A. Attributable Cost

It now is well established that cost attribution must be based on causality. Nat'l Ass'n of Greeting Card Publrs. v. United States Postal Service, 462 U.S. 810, 830 (1983). Moreover, as applied in current postal costing methodology, the **attributable cost** of a postal product is essentially equal to its **marginal cost**.[7] The only exception is **specific fixed** costs, which are also attributable, but generally are negligible. The definition and computation of marginal cost for each postal product have been analyzed and refined by the Commission and the Postal Service for over 40 years. Even if average incremental costs were adopted as the new price floor, they would be developed from that marginal cost base. Nothing about the

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[6] This paper was also cited by the Postal Service in its response to ChIR No. 2, Q. 3.

[7] "Attributable costs are a close proxy for marginal costs … even though they include a minor amount of product-specific costs." Docket No. RM2008-2, Order No. 115 at 15 and n.25.

current procedures for computing marginal cost needs to be changed. The procedures that the Postal Service and the Commission have been developing and refining for over 40 years remain in place. Nothing would be jettisoned. However, something more would be needed.

The Declaration of John C. Panzar of behalf of Amazon Fulfillment Services, Inc. defines marginal cost as follows:

> ***Marginal cost*** is the incremental cost of a single unit of output, or the cost avoided by not producing a single unit of output. In mathematical terms, marginal cost is the limit of the average incremental cost as the size of the increment approaches zero. Thus, the marginal cost of any particular service is defined as the partial derivative of total cost with respect to the volume of that service. [*Id*. at 5.]

This definition of marginal cost measures the cost caused by producing the **last unit of output** only. It deliberately **excludes** any and all other **costs caused by producing all increments of output** up to the last unit. Thus there is **no assurance** that a price equal to marginal cost will recover **all costs** which the existence of the product **causes** the Postal Service to incur. A price equal only to the marginal cost of the last unit produced, by failing to recover all costs which the product **causes** the Postal Service to incur, can force customers of other products to cross-subsidize the product's shortfall. This means that using attributable cost as a price floor will not prevent cross-subsidization. Consequently, Panzar's definition of marginal cost, which is widely accepted, still requires that another cost concept, also **based on causality**, be applied — **incremental cost**.

Initial comments of ACMA *et al.* offer the following comment regarding price floors:

> In Nat'l Ass'n of Greeting Card Publishers v. USPS, 462 U.S. 810 (1983) ("NAGCP IV"), however, the Supreme Court held

> that the Commission was free to set price floors **as low as attributable cost**. [*Id.* at 6 (emphasis added).]

ACMA *et al.* does not discuss the fact that, by allowing underwater products to exist, the Commission has implicitly allowed the existence of a price floor that is **below attributable cost**. Nor does ACMA *et al.* discuss that such a price floor is in direct conflict with the principle of preventing cross-subsidization. Finally, even accepting ACMA *et al.*'s analysis of the Supreme Court decision, it still allows the Commission to set a price floor that is above attributable cost, in line with incremental costs — what Panzar describes as the "standard in the regulatory economics literature."

B. Incremental Cost of a Product

The Declaration of John C. Panzar of behalf of Amazon Fulfillment Services, Inc., correctly defines incremental costs as follows:

> **Incremental costs** equal the costs that are **caused by** the production of a given subset of a firm's outputs. Stated conversely, incremental costs are the costs that would be avoided if **a given subset** of the firm's outputs **were discontinued**. The parallel emphasis on the concept of avoided cost is particularly important as a guide to intuition. … it is unambiguously clear that the only added costs that are equal to avoided costs are those that result when the product (or group of products) in question is added last. And, that is precisely the cost measured by the economic definition of incremental costs…. All measures of incremental cost share a fundamental trait in common: they **exclude, by definition, any costs that would still be incurred even if the specific increment of output were eliminated.** [*Id.* at 4-5 (emphasis added).]

Initial Comments of the Postal Service are in accord:

> To accurately calculate how much cost a specific product creates, one must calculate and compare the firm's total cost before and after the specific product is included in the firm's output mix.

> The incremental cost is the difference between the two.... Finally, the incremental cost test ensures that an individual product's revenue exceeds the total cost caused by the product and, therefore, that the product is not receiving a cross-subsidy. [*Id.* at 22.]

Neither the concept nor the computation of incremental cost have been extensively litigated before the Commission, unlike attributable cost. To apply this definition of incremental cost to the Postal Service, several points need to be addressed.

- First, incremental costs are causally related to products. Indeed, as defined in the Panzar Declaration, they are **just as causally connected to products as are currently measured attributable costs**. The Bradley Statement[8] concurs, stating: "a product's incremental cost is the <u>total</u> amount of cost **caused by** that product." *Id.* at 12 (emphasis added). Although incremental costs have not been the subject of extensive Commission litigation, incremental costs which comport with Panzar's definition fully meet any causality standard.[9]

- Second, marginal cost and incremental cost are neither identical nor equal to one another.[10] The Bradley Statement notes that "when the firm has decreasing

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[8] Michael Bradley, Analysis of UPS Proposals One and Two, and Supporting Report of Dr. Kevin Neels, submitted January 27, 2016, and referred to herein as the Bradley Statement.

[9] Comments that critique arbitrary cost allocation as not meeting the causality standard are irrelevant to understanding the appropriate roles for attributable and incremental cost.

[10] Initial Comment of NPPC correctly comment on attributable cost and incremental cost:

> In particular, UPS's Proposal One highlights that the current definition of attributable costs does not include inframarginal costs. For this reason, Professor Panzar has concluded, "**attributable cost is not an appropriate substitute for incremental cost.**" Panzar at 21. [*Id.* at 5 (emphasis added).]

marginal costs for a product, its average incremental cost will be above its marginal cost." *Id.* at 12 (emphasis added). Both attributable and incremental cost are **causally linked** to products, and each play an important role in pricing. In particular, to avoid cross subsidization, it seems clear that **average incremental cost** should be used to establish a **price floor** for each product. A price floor based on attributable marginal cost, which generally is less than incremental cost, is not guaranteed to prevent cross subsidization.

- Third, if the price of every product equals or exceeds a price floor equal to its average incremental cost, then every product can expect to see its revenues cover its respective incremental cost. Cross subsidies will cease to exist and no longer be a problem.
- Fourth, if prices for every product are set just equal to incremental cost, those prices will fail to produce revenues sufficient to cover aggregate costs, because the incremental cost of each product **excludes** any costs that still would be incurred even if the entire output were eliminated. That is, all common or joint costs are not included in the incremental cost of every product. Therefore, to cover these common or joint costs, the price of some products will need to exceed their incremental cost.[11] Markups and coverage should be based on

[11] The Bradley Statement says that "In multiproduct firms, there can be variable costs which are not caused by any individual products.… Inframarginal costs can arise from **common production** in which the cost driver is simultaneously shared among one or more products.… The only way that an inframarginal cost is assignable to a product is if <u>all</u> of the change in the cost driver is due to a change in just one product, as when computing incremental costs. *Id.* at 28-29 (emphasis added).

attributable cost, as they are now, **with the proviso that all marked up prices must exceed the average incremental cost floor**.

- Fifth, the incremental cost of a product consists of all costs caused by producing the **entire output** of the product. The **average incremental cost** is of course the average cost of producing the entire output, not just the last unit of output. As Bradley states: "[i]ncremental costs and marginal costs are precisely related. Incremental cost is just the sum of the marginal costs for all units produced. Consequently, the calculation of incremental cost requires identifying the portion of inframarginal costs that are caused by the provision of an individual product (or group of products)." Bradley Statement at 20. The term "incremental cost" can be and sometimes is used to refer to some specified increment or decrement of a product other than the entire output. The average cost over some specified increment or decrement of output may or may not be equal to the average incremental cost of the entire output, and should not be confused with the term "incremental cost" as that term applies to the entire output of a product.
- Sixth, because incremental costs by Panzar's definition exclude any and all costs that still would be incurred even if the specific increment of output were eliminated — *e.g.*, all common or joint costs would be **excluded** — in no way can incremental costs under this Panzar definition be characterized as constituting "fully distributed costing." If the price of every product were set just equal to incremental cost, aggregate revenues would fail to cover aggregate

> costs, probably by a wide margin, which also helps illustrate that, by Panzar's definition, **incremental cost does not constitute, or in any way imply or favor, fully distributed costing**. Any such criticisms are uninformed and intended to divert the Commission from following sound economic principles.

NPPC's Initial Comments also favor a resolution that would see attributable costs retained while incorporating incremental costs as an integral part of the annual review:

> [I]t would be appropriate for the Commission to conduct an **incremental cost test** not only for Competitive products, but also for market dominant products. Checking for the existence of **cross-subsidies** within market dominant products could prove useful. Doing so could help achieve the objective of a "just and reasonable rate schedule," a term that implies that rates are compensatory and that cross-subsidies are not present unless justified by law or public policy. 39 U.S.C. 3622(b)(8) … The Commission should consider applying an incremental cost test **even if it does not adopt Proposals One or Two in any respect, because it has never applied an incremental cost test to market-dominant products in the decade since enactment of the PAEA**. [*Id.* at 9-10 (emphasis added).]

If the Commission adopts each of the two preceding definitions of cost for use in ratemaking — incremental cost for establishing a rigorously enforced price floor, and attributable cost for determination of coverages — an expanded terminology would be helpful. To start, incremental costs include both (i) marginal and (ii) attributable costs. However, they also include **more** — *i.e.*, some portion (to be determined) of inframarginal costs. For clarity, those costs that are **excluded from** attributable costs but **included in** incremental cost will be referred to here as costs that are "allocated" — not attributed. Thus, to the extent that one is talking about using incremental costs to establish a price floor, and including some portion of inframarginal costs in incremental costs, those inframarginal costs are said here to be allocated, not attributed.

It is important to distinguish between (i) the definition of incremental cost, (ii) its role in pricing, and (iii) how the incremental cost of products is computed (the issue regarding which much of the debate in the Initial Comments occurs).

IV. Computation of Attributable and Incremental Cost

The filing of UPS Proposal One has performed a valuable service by focusing attention on the large amount of variable costs that are described as "inframarginal costs" and not now attributed. The issue raised by UPS Proposal One is whether some or all of those inframarginal costs should be considered part of incremental costs, *i.e.*, the price floor.[12] UPS Proposal One would allocate all of those volume variable costs, using existing distribution keys or, possibly, an approach based on Shapley values. In response to ChIR No. 1, Q. 5, UPS submitted a table ("Table 1") showing the effect of allocating inframarginal costs to all products, including market dominant products, using its methodology.

Panzar, in his 2014 paper prepared for the Commission, The Role of Costs for Postal Regulation, states that "[u]nfortunately, the **attributable cost** of a product as developed by the CRA **does not adequately measure** that product's **incremental cost**." *Id.* at 16. He then develops his Table 1, which shows the difference between incremental costs and attributable costs as a function of driver share and component cost elasticity. *Id.* at 24. Although his

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[12] The main interest of UPS is the cost floor for competitive products, which it believes should be based on incremental costs. However, UPS states that inframarginal costs should be attributed.

Table 1 demonstrates that the effect of inframarginal costs on incremental costs can, under certain conditions, be major, Panzar does not offer any analysis of how large would be those inframarginal costs that would be assigned to any individual product. That is, Panzar's study does not have a table comparable to that of UPS, and therefore there is no straightforward way to compare the average incremental cost of individual products under each of the two approaches.

A. Postal Service Comments

NPPC reminds us that the Postal Service "has never applied an incremental cost test to market-dominant products in the decade since enactment of the PAEA."[13] This Postal Service inaction has created a void which UPS has sought to fill. The Postal Service's Initial Comments and the accompanying Bradley Statement reject the UPS approach to allocation of inframarginal costs to incremental cost. But the Postal Service does not offer its own estimate of incremental costs by product in this docket. As of now, the Commission has no estimate of the incremental cost for individual competitive and market dominant products, for FY 2015 or any preceding year, other than that of UPS.

B. ACMA Comments

ACMA describes the 30+ year development of the present costing system. In general, ACMA defends the existing system, including the use of marginal cost, as superior to UPS

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[13] The response to ChIR No. 6, Q. 1, states that "**The Postal Service confirms that since enactment of the Postal Accountability and Enhancement Act of 2006, it has neither calculated nor produced incremental costs for individual competitive products,** but has instead calculated and presented the incremental cost for the group of competitive products." (Emphasis added.)

Proposal One. Despite its rather glowing praise for the existing system, Initial Comments of ACMA admit that:

> ACMA has pointed to apparently anomalous and otherwise questionable outcomes of the current costing system. See Docket No. ACR2014, Initial Comments of ACMA (February 2, 2015). [*Id.* at 32, n.38.]

ACMA does not elaborate on the apparent inconsistency between (i) its 2016 stout defense of a costing system that has been under continuous development of over 40 years and that produces consistent results year after year, and (ii) its 2015 assertion that the costing system results in "anomalous and otherwise questionable outcomes." If ACMA is correct that the Postal Service's costing system produces anomalous outcomes after more than 40 years of development and refinement by a large number of interested parties, then ACMA must believe that the current costing system would need a serious re-think. That is what UPS has done.

C. PR Comments

The PR notes that some costs considered common or joint are nevertheless included in the attributable cost of products by means of distribution keys considered appropriate for the task:

> Economists generally agree that it is suboptimal to allocate costs to products when their production contains economies of scale or scope. This is why the **distribution key** assumption is so important. It assumes that, in spite of the presence of economies of scale and scope at the component level, each product's part of the distribution key accurately captures its share of the economies of scale and scope present in each component. Using distribution keys is a cost allocation method, because **it allocates joint and common component-level costs caused by the production of many products, to individual products.** Even though the Commission has not generally supported the allocation of joint and common costs, it has accepted using distribution keys

> because, even though one cannot determine the share of common, component-level costs caused by individual products using distribution keys, **using distribution keys assumes the proper allocation of joint and common component-level costs is achieved.** [*Id.* at 22, n.36 (emphasis added).]

That said, the mere fact that some cost is common or joint should not, *per se*, preclude it from being allocated to products' incremental cost. The PR points out that:

> With the Commission's decision to accept the notion that these component level costs can be allocated to products using a distribution key, the Commission implicitly accepted that there is a causal link between a component's volume variable cost that is jointly caused by products and the products that utilize that component which can be perfectly attributed to each product according to the extent to which it contributes to component-level common costs. … the same rationale used to justify attributing component-level volume variable costs to products can be applied to inframarginal cost. **Although inframarginal component costs include joint and common costs, so do volume variable component costs.** In other words, all variable component costs are jointly caused by products. [*Id.* at 26 (emphasis added).]

The PR is on point in a number of ways. At a minimum, the Commission needs to compute incremental costs for each individual and market dominant product, and it should reconsider whether the currently accepted methodology is too narrow.

V. Product Pricing

Other than the Valpak Initial Comments, all parties mention economic principles applicable to pricing only briefly, if at all, while discussing the definition and development of economic costs at considerable length. General agreement exists that efficient pricing is the goal of economic costing.

Initial Comments of the Postal Service state that:

> [the Postal Service] uses marginal costs as the starting point for setting prices. The Postal Service and the Commission are both well aware that, in order to cover its total costs, the Postal Service **needs to set its prices above its marginal costs.** [*Id.* at 24 (emphasis added).]

The Postal Service does not elaborate. Without further explanation, prices that exceed marginal cost could be set by the Postal Service in an economically efficient manner, or across-the-board with no consideration given to demand considerations, or just willy-nilly. Any of the preceding would satisfy the PAEA and the Commission, provided that the price cap is not exceeded.

The Bradley Statement contains the following brief discussion relating economic costs to pricing:

> in order to not incur a financial loss by providing service, **it should always be the case that a product's price at least equals its marginal cost.** Use of marginal costs to set prices also provides a basis for **economically efficient pricing**. [*Id.* at 10 (emphasis added).]
>
> In sum, the calculation of marginal cost **and incremental cost** provides **all of the cost measures the Postal Service needs for efficient pricing** that is in compliance with the law. [*Id.* at 31 (emphasis added).]

Although Bradley does not define or discuss the characteristics of "economically efficient pricing," it should be clear that non-compensatory pricing of underwater products does not conform with any standard of economically efficient pricing.

It is economically inefficient for the Postal Service to price any product so that it does not recover all incremental costs of the product. Always, this causes the Postal Service to cross-subsidize those products with income derived from other mailers. Moreover, pricing below average incremental cost increases volume over what it otherwise would be, resulting in unnecessary losses and cross-subsidies. And sometimes there is yet another ripple effect, as mailers shift volume from profitable to unprofitable products, resulting in lost contribution to the Postal Service. Lastly, yet another undesirable effect in Standard Mail is that mailers which use the artificially overpriced products are compelled to subsidize their business competitors using products with noncompensatory prices, so that Postal Service pricing actually helps chose winners and losers in a competitive marketplace, which government should never be allowed to do.

The second above-quoted statement by Bradley implies that requirements for efficient pricing by the Postal Service — *i.e.*, calculation of marginal and incremental cost — are akin to a two-legged stool. The problem for market dominant products is that the Postal Service and the Commission have only one leg: marginal cost. As others have observed, in the 10 years since PAEA was enacted, the Postal Service has never calculated incremental cost for market dominant products.

The Declaration of John C. Panzar on behalf of Amazon Fulfillment Services contains a lengthier discussion of economically efficient pricing:

> Economists generally agree that **economic efficiency and the avoidance of cross-subsidization** requires that the prices charged for products offered by multiproduct firms like the Postal Service satisfy three tests: **(1) the price charged for an individual (or marginal) unit of output must cover its marginal cost;** (2) **the average revenue** received for any larger increment of output of a product **must cover its average incremental cost;** and (3) the total revenue received from two or more products combined must cover the incremental costs of the same products combined. Above these price floors, a regulated firm like the Postal Service should be allowed to recover the **shortfall between incremental costs and total costs** by setting **markups** that, in the judgment of Postal Service management, maximize the total contribution

> generated by the Postal Service's outputs, constrained only by the maximum rate standards and restrictions on discrimination that legislators and regulators set. Regulators should not impose minimum price floors that include costs that are not caused by the increment of output being costed (in the sense of being avoided if the incremental output were not provided). [*Id.* at 2-3 (emphasis added).]

It is notable that the Postal Service, although claiming to adhere scrupulously to expert advice on costing, cavalierly ignores the pricing advice from those same economic experts as evidenced by (i) underwater products that continue to have non-compensatory prices year after year, and (ii) across-the-board rate adjustments, especially in exigent pricing dockets when it has enhanced flexibility because the class-based price cap is not applicable, as in the most recent exigent pricing docket.

According to Panzar, the Postal Service should be "allowed to recover the **shortfall between incremental costs and total costs** by setting **markups** that, in the judgment of Postal Service management, **maximize the total contribution** generated by the Postal Service's outputs, constrained only by the maximum rate standards and restrictions on discrimination that legislators and regulators set." Since Panzar offers no other criterion as a guide for setting prices, his statement implicitly assumes that the Postal Service has a paramount interest in "maximizing contribution." Yet, Postal Service pricing is no way reflects a paramount interest in "maximizing contribution." Given the Postal Service's penchant for nursing underwater products with non-compensatory prices, and the continuing billion-dollar losses on those products, it is far from clear that the Postal Service has any abiding interest in setting prices to maximize contribution. It never has claimed to have a pricing model that can be used to maximize contribution. It has exhibited no interest in the model offered by Valpak for Standard

Mail. In fact, it is not clear that the Postal Service uses any model (maximizing or otherwise) or systematic procedure for setting prices.[14] Mailers deserve more transparency as regards the motives underlying price adjustments. Simply stating that a price adjustment adheres to the price cap is not a sufficient explanation for price adjustments that have no rational explanation vis-a-vis Panzar's maximize contribution criterion.

Discussion of pricing in the PR's Initial Comments takes a somewhat different tack. The PR's concern is not about avoiding cross-subsidies or setting economically efficient prices, but how pricing effects financial viability of the Postal Service:

> When the PAEA was enacted into law, the Commission's responsibility changed from price setting to determining the Postal Service's compliance with applicable laws. Under the PAEA, pricing is separated from cost attribution. The Commission no longer sets prices. Congress expressly gave this authority to the Postal Service. This, in turn, **increased the need for the Commission to ensure products cover their costs attributable costs** based on reliably identified causal relationships. With this change in responsibilities, cost coverage has increased in importance, at least as far as **the Commission's ability to ensure the viability of the Postal Service.** … The Commission cannot alter the price cap to improve the financial viability of the Postal Service, but, **its decisions with regard to costing can alter the financial viability of the Postal Service.** [*Id.* at 24 (emphasis added).]

Of course, the PR is correct that the Commission no longer sets prices. But now, the Commission generally acts as though it has no responsibility for either ensuring that products

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[14] The Christensen Associates calculations filed in Docket No. ACR2012 (Library Reference USPS-FY12-43) do not even purport to maximize contribution. The USPS OIG Report on Postal Service pricing and lack of systemization could not identify any comprehensive, documented pricing processes. *See* USPS OIG, Market Dominant Price Adjustment Filings, Report No. CP-AR-16-003 (Jan. 13, 2016).

cover their attributable costs or for improving the Postal Service's financial viability. The PR's statement includes implicit assumptions that are inconsistent with the Commission's "light-handed" approach to regulation.

VI. Conclusions and Recommendations.

UPS Proposal One, along with the three Commission-sponsored papers by Panzar, McBride, and Cohen-Waller, have helped demonstrate the need for the Postal Service and the Commission to develop incremental costs for each market dominant product. This now glaring void in available cost information exists despite the fact that, as Panzar has stated, incremental cost is the accepted standard in regulatory economics for avoiding cross-subsidization. Also, as Panzar has demonstrated, incremental costs that conform to his definition are just as "causal" as current estimates of attributable cost. Incremental cost include both attributable cost as well as other costs (non-marginal) costs caused by a product.

With respect to UPS Proposal One, Valpak continues to take no position on whether some or all of that particular proposal should be adopted. Valpak, does, however, offer the following recommendations with respect to incremental cost generally.

The Commission should adopt incremental cost as a separate and distinct measure of costs caused by postal products, while not altering or jettisoning current calculations of attributable costs in any way. It is time for the Postal Service to develop fully and promptly, for both competitive and market dominant products, incremental costs as expounded by it own expert, witness Bradley. Average incremental cost for each market dominant product should be computed according to the accepted incremental cost methodology (as approved by the

Commission in Order No. 399)[15] and included in both the CRA and the ACR, and rigorously observed as a cost floor for each of the Postal Service's products. The Postal Service retains pricing flexibility within the law, so long as (i) all product prices are equal to or exceed their incremental cost floor at all times unless prevented from so doing by the price cap on the applicable class of mail, and (ii) collectively and cumulatively the price adjustments within each class of mail do not exceed the cap for each respective class of mail.

Any price below the incremental cost floor should be viewed as non-compensatory. Unless strictly prohibited by the price cap, the Postal Service should be required to comply with both the letter and spirit of PAEA and eliminate promptly all cross subsidies within market dominant products by bringing all non-compensatory prices up to a compensatory level at least equal to the incremental cost floor.

The Postal Service has approximately $13 billion of variable costs, described as inframarginal costs, that are not attributed. By Panzar's reckoning, some (but not all) of those costs are candidates for inclusion in the incremental cost of individual products. If the Commission determines that its methodology (*e.g.*, as discussed in Order No. 399) for computing and allocating inframarginal costs to individual products is no longer adequate for the task, it should (i) undertake research on its own initiative, or (ii) convene a special docket, or (iii) do both of the preceding to develop an accepted methodology for computing and reporting annually incremental costs, and (iv) amend its periodic reporting rules to require the

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[15] *See* ChIR No. 3, Q. 3.

Postal Service to develop incremental costs for all market dominant and competitive products pursuant to Commission-approved methodology.

Respectfully submitted,

/s/

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